

EXHIBIT 1

**BEFORE THE
FEDERAL COMMUNICATIONS
COMMISSION**

Washington, DC 20554

In the Matter of

CC Docket No. 99-24

**Petition of Bell Atlantic Telephone
Companies for Forbearance from
Regulation as Dominant Carriers in
Delaware; Maryland; Massachusetts; New
Hampshire; New Jersey; New York;
Pennsylvania; Rhode Island; Washington,
D.C.; Vermont; and Virginia**

**REPLY AFFIDAVIT OF KARL McDERMOTT AND WILLIAM E.
TAYLOR**

ON BEHALF OF

BELL ATLANTIC

April 8, 1999

I.	INTRODUCTION	1
II.	MARKET DEFINITIONS.....	1
A.	RELEVANT GEOGRAPHIC MARKET	1
B.	RELEVANT PRODUCT MARKET.....	7
III.	ANTI-COMPETITIVE CONCERNS ARE WITHOUT MERIT	7
A.	IF GRANTED FORBEARANCE, BELL ATLANTIC WOULD NOT BE ABLE TO CROSS-SUBSIDIZE	7
B.	ALLEGATIONS OF ENTRY-DETERRENT STRATEGIES ARE FLAWED	9
C.	ADDITIONAL ANTI-COMPETITIVE CONCERNS ARE UNFOUNDED.....	13
IV.	MARKET SHARE SHOULD NOT BE THE BASIS FOR FORBEARANCE.....	14
A.	CONTRARY TO INTERVENORS' CLAIMS, POTENTIAL COMPETITION CAN DISCIPLINE PRICE.....	14
B.	BELL ATLANTIC'S SPECIAL ACCESS PRICES ARE NOT SET AT SUPRA-COMPETITIVE LEVELS.....	18
C.	CAPACITY IS THE CORRECT BASIS TO MEASURE MARKET SHARE	20
V.	CONCLUSIONS.....	21

I. INTRODUCTION

1. Some of the parties commenting on Bell Atlantic's forbearance petition argue that Bell Atlantic still retains market power and that the requirements for the Federal Communications Commission ("FCC" or "the Commission") to grant forbearance for Bell Atlantic's special access services have not been met. Nothing in these arguments alters our conclusion that Bell Atlantic does not possess market power in the provision of special access services and that economic welfare would increase if the Commission granted Bell Atlantic's petition. Many of the parties that are opposing Bell Atlantic's petition are actual or potential competitors who have a vested interest in maintaining pricing constraints on Bell Atlantic in order to retain a competitive advantage.

2. In this Reply Affidavit, we respond to the economic issues raised by the intervenors. Claims that Bell Atlantic retains market power in the provision of special access are based, in part, on incorrect determinations of the relevant product and geographic market. Moreover, claims by some of the parties that forbearance would unleash a wave of anti-competitive pricing and conduct on the part of Bell Atlantic are without merit and entirely speculative. In order to obtain the benefits envisioned in the Telecommunications Act of 1996 ("the Act"), market forces, rather than continued regulation, should be the primary vehicle for determining economic outcomes.

II. MARKET DEFINITIONS

A. Relevant Geographic Market

1. Some parties dispute our definition that the relevant geographic market for Bell Atlantic's special access services in each of its states is the entire state itself. Our geographic market definition is criticized by Ordoover and Willig [Affidavit at 16] as being too broad while Time Warner [Comments at 6-7] argues that it should be even broader. Contrary to the claims of Ordoover and Willig, our conclusion that the entire state is the relevant geographic market is not

based on an “unwarranted assumption”. As we discussed in our previously filed Affidavit [at 6], an important factor in defining the relevant geographic market is whether Bell Atlantic has the power to unreasonably price discriminate—i.e., to charge substantially different prices unrelated to cost or demand differences—in different regions of the geographic area. We concluded that based on the manner in which special access services are bought and sold by the major buyers—namely the “Big Three” Inter-Exchange Carriers (“IXCs”) (AT&T, MCIWorldcom and Sprint)—that special access customers are able to leverage their demand in urban markets in order to prevent unreasonable price discrimination in more rural parts of the state.

2. While Ordoover and Willig [Affidavit at 16] are correct that the Commission has rejected the use of state-wide geographic markets for exchange access, the approach we use in finding that the entire state is the relevant geographic market for special access is consistent with the methodology the Commission used in these decisions to define the market. Moreover, when taking into account the manner in which special access services are bought and sold, one can conservatively conclude for the purposes of forbearance that the relevant geographic market is the state. For example, the Commission determined that while each point-to-point connection constituted a separate geographic market, groups of point-to-point connections could be considered relevant markets where consumers faced the same competitive conditions.¹ The Commission recently provided a methodology for determining the appropriate geographic market for communications services in general.² It defined the relevant geographic market by considering the territories over which a particular relevant product is or could readily be marketed.³ Therefore, how special access services are marketed and sold is a critical piece of evidence in determining the relevant geographic market. It is our understanding that special

¹ *In the Matter of Application of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control of MCI Communications Corporation to WorldCom, Inc.*, September 14, 1998, 13 FCC Rcd 18025, at ¶ 166.

² *In re Application of 360 [degrees] Communications Company Transferor, and ALLTEL Corporation Transferee, For Consent to Transfer Control of 360 [degrees] Communications Company and Affiliates*, December 30, 1998, Report No. LB-98-50.

³ *Ibid.*, at ¶ 15.

access services are marketed and sold at a level that is much larger than an MSA or LATA basis. In fact, Bell Atlantic markets and sells special access services at the “footprint” level.⁴ Bell Atlantic has one account manager per IXC for the footprint, and these account managers negotiate with carriers on a footprint basis. This arrangement reduces transactions costs for both parties and is efficiency-enhancing, but it also increases the IXCs’ ability to bundle demand and use leveraging as a means of disciplining Bell Atlantic’s prices in those areas where competition is not as robust. This market characteristic prevents Bell Atlantic from unreasonably discriminating between customers in urban and more rural areas and therefore makes our use of the state as a relevant geographic market conservative.

3. This view that the relevant market is at least the entire state and that special access services are bought and sold at the footprint level is supported by the comments of Time Warner, which opposes Bell Atlantic’s petition. Time Warner states that [Comments at 7]:

Bell Atlantic’s pricing strategies reflect its view that the market for special access services is not limited to a statewide geographic market. For example, Section 7.2.13 (D) (3) (c) of Bell Atlantic’s FCC tariff No. 1 (governing special access services), permits a customer to aggregate multiple LATA plans under the tariff. Section 7.5.18 (A) (2) of the same tariff demonstrates that a special access customer will enjoy lower rates with a large number of DS0 equivalent channels ordered. As a result, customers have an incentive to aggregate their special access purchases on a multiple-LATA, including multiple-state, basis. Bell Atlantic would only include multiple-LATA offerings in its tariff if customers demanded and purchased special access services that covered such large geographic areas. [Footnotes omitted]

Time Warner continues that⁵ [Comments at 7]:

aside from state governments, there is nothing significant about state boundaries that would cause a special access customer to demand the service in accordance with those boundaries.

⁴ A “footprint” is the serving territories in all the states served by Bell Atlantic.

⁵ Time Warner [Comments at 7] also cites MCI Worldcom as stating: “most IXCs...purchase access services throughout [the ILEC’s] region.” See *Petition of SBC Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Dedicated Transport Services in Fourteen Metropolitan Service Areas*, CC Docket No. 98-227, MCI Worldcom Opposition at 3 (filed Jan 21, 1999).

Moreover, Comments submitted by Marriott also contain evidence that special access customers do indeed purchase services at the footprint level. Marriott states that it [Comments at 2]:

is interested in contracting for our total volume of special access purchases from all of our locations throughout the Bell Atlantic region, over a term which is beneficial to our operations and to the service providers.

Clearly, our argument that special access customers are able to bundle demand and that they purchase special access services on a geographic basis that is much larger than a LATA or MSA, is supported by the available evidence. Our conclusion, therefore, that the relevant geographic market is the state is not only correct but, based on the available evidence, is conservative.

1. Leveraging demand can constrain prices in less competitive areas of the state

6. Our assertion that the relevant geographic market is the state is based on the proposition that Bell Atlantic is not able to unreasonably price discriminate between customers in urban and rural areas. This proposition, in turn, is supported by our assertion that major special access customers are able to leverage their demand in urban areas in order to obtain competitive prices in rural parts of the state. This position is criticized by AT&T [Comments at 19], Ordoover and Willig [Affidavit at 13], Time Warner [Comments at 27] and MCI [Comments at 19].

7. The reasons proffered by Ordoover and Willig are flawed. Contrary to their assertion [Affidavit at 14], and that of Time Warner [Comments at 27], supply alternatives are readily available in most urban areas, thereby giving customers the option of moving demand to competitors or at least credibly threaten to do so. Bell Atlantic provides evidence in its Petition that there are numerous competitors in urban markets that provide customers the option of selecting from multiple suppliers. Bell Atlantic's Reply Comments rebut the assertion by AT&T [Comments at 6-7] that the evidence relied upon by Bell Atlantic was flawed and based on unproven rival technologies. Moreover, Attachment 1 to this affidavit contains a map of competitors' facilities in two urban markets in Bell Atlantic's territory (Syracuse and

Washington D.C.). Attachment 1 clearly shows that competitors' fiber facilities provide the alternatives needed in order to be able to credibly threaten to switch suppliers if Bell Atlantic prices special access anti-competitively in rural markets.⁶ As can be seen from the maps, the areas in both cities that contain most of the customers who purchase special access services are within a mile of a competitor's network. As discussed below, competitors do not have to be connected to each and every building for Bell Atlantic to price competitively. The key determinant is whether in response to a significant and non-transitory price increase, competitors are able to build out to reach consumers. We explain below why barriers to expanding are low.

8. Ordoover and Willig also provide an example [Affidavit at 14] that purports to show that we "greatly exaggerate" the constraint that competition in urban areas can exert on pricing in those parts of the state where there is no competition. Their example does no such thing because it is not an accurate representation of the special access market. The example is misleading because it does not depict the actual relationship between demand in urban and rural parts of the state and therefore does not depict the reason why leveraging is credible. For every unit of demand in the rural part of the state, there are likely to be almost 10 units in the urban part.⁷ Demand is not likely to be equally split, as Ordoover and Willig suggest, between urban and rural parts of the state. Because urban areas serve higher volumes of demand, the Big Three can credibly threaten to shift their traffic to suppliers in urban areas if prices are not satisfactory in rural areas. Since there is likely to be significantly greater demand in urban parts of the state, the incumbent would face a much greater profit loss if a customer moved its traffic to an alternative supplier in the urban area.

9. Contrary to Ordoover and Willig, customers can obtain better overall rates through the credible threat of moving their traffic to other suppliers where alternatives are available. There

⁶ As discussed in more detail below, a customer does not have to be physically connected to an entrant's network in order to discipline Bell Atlantic's special access prices.

⁷ Table 1 in our Affidavit [at 10] indicates that less than 10 percent of equivalent DS1 demand is in rural parts of the state.

does not have to be an alternative supplier in the rural area in order for the threat to be credible. Bell Atlantic derives almost all of its earnings on special access from purchases in urban areas. Bell Atlantic would not risk losing its large demand in urban areas by over-pricing the small amount of demand in rural areas at monopoly levels. There is little demand in rural areas that would enable Bell Atlantic to capture large profits from monopoly pricing in rural areas, and if it did price monopolistically, higher rural prices would lead to even fewer units of demand and further competitive entry into rural areas.

10. Using Ordoover and Willig's example [Affidavit at 14] illustrates our point. Assume that instead of one DS1 channel to each site there is one DS1 channel to the rural site and ten DS1 channels to the urban site. Assume that monopoly prices are \$150 in the rural area and that competitive prices are \$100 in the urban area (same as in the Ordoover and Willig example), that a normal profit for each unit served is 10% and that marginal costs are the same across the state.⁸ Total profits in the rural area are only \$60, while in the urban area they are \$100. Clearly, Bell Atlantic has a strong incentive to retain customers in the urban market because the majority of its special access profits come from these customers, not from rural customers. Bell Atlantic would not risk losing these customers in order to exploit putative market power in rural areas because they would simply lose much more than they could potentially gain.

11. Time Warner's criticism of our leveraging argument [Comments at 26-27] that smaller customers would not enjoy the benefits of leveraging is also incorrect. As we indicated in our Affidavit [at 8], smaller special access customers are also able to take advantage of the leveraging available to large IXCs through the resale and shared use offered by large IXCs, even if they do not demand service in both rural and urban areas. It is the power of arbitrage that benefits the small customer, an arbitrage that is made possible by the large IXCs' ability to leverage.

⁸ This is conservative since the incremental costs are likely to be higher in the less densely populated rural areas.

B. Relevant Product Market

12. Time Warner [Comments at 8-9] argues that our relevant product market is too narrow because bundling leads to a larger product market than just special access. Along with Ordoover and Willig [Affidavit at 17], Time-Warner suggests that our assertion [McDermott & Taylor Affidavit at 5] that we are being conservative by choosing to look only at special access services is incorrect because the inclusion of local exchange and switched access would lead to a higher market concentration and thereby less reasons for granting forbearance. Both Ordoover and Willig and Time-Warner are wrong.

13. The question at issue is whether Bell Atlantic can safely be given regulatory forbearance for special access, not switched access and not for bundles of switched and special access services. All that matters for this decision is whether Bell Atlantic would be able to increase special access prices if price regulation were removed. Clearly, the inclusion of switched access as a substitute product for special access in the relevant market does not diminish the alternatives that special access customers have. In fact, it can only increase them. Hence, the recognition of switched access as a substitute for special access can only reduce Bell Atlantic's ability to raise special access prices, irrespective of the market structure for switched access services. The arguments offered by Time-Warner and Ordoover and Willig actually demonstrate that reliance on market share and market concentration measures can be misleading in evaluating market power—the ability to raise price.

III. ANTI-COMPETITIVE CONCERNS ARE WITHOUT MERIT

A. If Granted Forbearance, Bell Atlantic Would Not Be Able to Cross-Subsidize

14. Some parties argue that if granted forbearance, Bell Atlantic will have the ability and incentive to cross-subsidize by using monopoly profits to support pricing special access below

cost.⁹ These parties ignore the important effect that price-cap regulation has on a carrier's ability to cross-subsidize its competitive services. Rate-of-return regulation could provide the regulated firm with an incentive to misallocate costs from competitive to non-competitive services.¹⁰ It is theoretically possible that predatory pricing for a competitive service may be combined with higher prices for non-competitive services to offset the losses from predation. Price-cap regulation, on the other hand, provides the well-known benefit of eliminating the ability and incentive of the regulated firm to cross-subsidize competitive services because a regulated firm cannot raise prices on regulated services to recoup losses on other services, whether regulated or not.

15. Concerns raised by Time Warner [Comments at 28] that "the Commission's price cap scheme has not removed Bell Atlantic's incentive and ability to engage in cross-subsidy because the price cap plan is designed to consider explicitly underlying ILEC costs" are unfounded. The remaining vestigial ties between accounting earnings and prices were eliminated when the Commission removed earnings sharing provisions in the price cap plan.¹¹ Similarly, productivity offsets in federal and state plans are almost always set with reference to: (i) the industry productivity experience rather than the productivity experience of a single firm; and (ii) the total company productivity growth, rather than the productivity growth for a subset of services. In these circumstances, the ability of a LEC to shift costs from one service to another or to strategically misallocate joint and common costs would have a negligible effect on future values of the productivity offset and the future course of its telephone prices under price-cap regulation.

16. Moreover, the ability to cross-subsidize competitive services with revenues generated from monopoly services depends on Bell Atlantic's ability to price local exchange services above

⁹ Sprint [Comments at 2-3, 7], ALTS [Comments at 7], Hyperion [Comments at 7], Time Warner [Comments at 28].

¹⁰ William J. Baumol, *Superfairness*, The MIT Press, Cambridge, Massachusetts, 1986, Chapter 6.

¹¹ See *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, Fourth Report and Order, Released May 21, 1997.

competitive levels. Not only does regulation at the state level prevent this from happening, but the fundamental changes brought about since passage of the Act—e.g., removal of legal, regulatory and economic barriers to entry— clearly alter the market structure of the local exchange market. Barriers to entering these markets are significantly lower than they were prior to the Act, and under current conditions Bell Atlantic does not have the ability to price local exchange service at a monopoly level so as to recoup any losses from pricing special access services below cost.

17. Finally, the allegations made by Sprint [at 6] that Bell Atlantic would be able to charge high interconnection prices and degrade interconnection quality is specious and should not be a reason for denying Bell Atlantic's request. Interconnection prices and quality (in common with other wholesale services) are heavily regulated by state commissions and are likely to remain heavily regulated for some time. Prices for interconnection are either the subject of FCC Order or the result of negotiation and/or arbitration, and cannot be changed unilaterally by Bell Atlantic.

B. Allegations Of Entry-Deterrent Strategies Are Flawed

18. Time Warner [Comments at 22] alleges that if granted forbearance Bell Atlantic could engage in pricing strategies designed to stop potential competitors from entering the market and to discourage existing competitors from expanding. They raise the theoretical possibility that Bell Atlantic would act anti-competitively by setting special access prices low, "although not necessarily below cost". This would send a signal to higher cost entrants not to enter and to actual competitors not to expand and would also permit Bell Atlantic to establish itself as a ruthless competitor. In support of these theories, they cite an article by Janusz A. Ordover and Garth Saloner.¹² Time Warner's position is contrary to economic principles and based on

¹² Janusz A. Ordover and Garth Saloner, "Predation, Monopolization, and Antitrust," in *Handbook of Industrial Organization*, Richard Schmalensee and Robert Willig, eds., Vol. I, 1989 Elsevier Science Publishers.

game-theoretic results that are hard to find in actual market settings and hard to separate from normal competitive practices.

19. Established economic principles indicate that pricing services at levels approaching cost—such as Long Run Incremental Costs (“LRIC”)—is not anti-competitive. Anti-competitive concerns arise when prices are below cost and as discussed above, Bell Atlantic does not have the ability to recoup losses from below-cost pricing. Pricing down toward cost to meet competition is the essence of the competitive process, and is precisely what policymakers envisioned when passing the Act. Not only is pricing toward cost perfectly consistent with competitive practices, but consumer welfare increases due to lower prices. This view is echoed by AT&T in earlier filings made before the Commission.

In all events, the competitors’ claim that single-customer offers are predatory is wrong, and the result they seek is antithetical to the Commission’s pro-competitive policies. The Supreme Court has held that lowering prices in response to a competitor’s offer in order to retain or attract business ‘often is the very essence of competition,’ and benefits consumers so long as prices remain ‘above predatory levels.’ That is true whether the price cuts are general or limited to specific customers.¹³

20. The Commission should be especially skeptical of claims made by actual or potential competitors that pricing flexibility will permit Bell Atlantic to price anti-competitively. This is especially the case when underlying claims are based on the game-theoretic propositions espoused by Time Warner. In most instances, such conduct is not anti-competitive but is characteristic of healthy interaction among competitors, provides market participants the incentive to achieve greater efficiencies, provides consumers with lower prices and leads to overall gains in economic welfare. The fundamental flaw in their position is that there are no clear rules the Commission could adopt to prevent the putative anti-competitive pricing asserted by Time Warner. Assuming for the moment that pricing low, but above cost, is anti-competitive—which it is clearly not—how will the Commission determine whether the price

¹³ AT&T *Reply Comments*, CC Docket 90-132, September 18, 1990.

offerings are too low? What clear rules would guide the Commission? How would the Commission determine whether price offerings to some customers were competitive, but to others anti-competitive? Time Warner presents no solution other than continued rate regulation and its position is contrary to current Commission policy that permits incumbents to price down to average cost on a tariff entity basis.¹⁴ Time Warner's position actually would lead to increased control on Bell Atlantic's pricing, something which is definitely not efficiency-enhancing.

21. In previous work, Dr. Ordover has taken a different view of the issue:

[Examples of predatory conduct]...are difficult to distinguish from and, in fact, are a part and parcel of market rivalry that economists find salutary for economic welfare, that policy-makers wish to promote, and that business leaders often deplore (but find unavoidable).¹⁵

Moreover, Ordover and Saloner find that:

These theoretical findings and prescriptions are difficult to translate into workable and enforceable standards that in *actual market settings* would, without fail, promote conduct that enhances social welfare and would discourage conduct that harms welfare.¹⁶

22. Time Warner [Comments at 23-24] and Ordover and Willig [Affidavit at 9 and 15] make the insupportable claim that competitors are likely to have higher incremental costs. They argue that competitors are at a disadvantage because, while Bell Atlantic has already sunk its investment to provide service, competitors must sink investment in the ground and will only do so if they have a reasonable expectation that the costs would be recovered. This argument is

¹⁴ As we have already argued in our Affidavit, current pricing flexibilities are insufficient and economic welfare would increase as a result of forbearance.

¹⁵ Ordover and Saloner at 538, *op cit* 13.

¹⁶ *Ibid.*, at 538.

incorrect because it is based on a short-run perspective. While Ordover and Willig are correct that prior to being incurred, sunk costs are part of incremental costs, in the long run incumbents, existing competitors, and new entrants continually face the same decision—whether to incur costs that, once incurred, will become sunk to continue to provide service or increase production. While at any given period of time entrants may have to incur costs that will become sunk that incumbents do not have to incur, on a going-forward basis both will have sunk costs to recover. In fact, there will be instances when the incumbent will have sunk costs while the entrant does not. This is not anti-competitive, however, because it does not provide Bell Atlantic an advantage over its rivals. It does not materially affect one firm's LRIC *vis-à-vis* another firm's. And it is LRIC that is used as a proper basis for determining whether pricing is anti-competitive.

23. Moreover, what they fail to mention is that new entrants, unlike Bell Atlantic, are not encumbered by legacy networks. Bell Atlantic maintains a ubiquitous switching network that affects its costs for all services including special access. Entrants, on the other hand, have no such constraints when providing special access service. In fact, entrants may well have a cost-advantage because they are free to use the most modern technology, while it is not economically justified for Bell Atlantic or current competitors to constantly replace older technology.

24. More important, a firm's cost advantage, regardless of which carrier possesses it, is not anti-competitive. Indeed, a policy of penalizing lower-cost producers ultimately harms the consumer. Each carrier brings its relative advantages and disadvantages to the marketplace and competes on the basis of forward-looking incremental costs. The Commission should not adopt

a policy that favors certain competitors by inhibiting economic efficiency and blocking lower prices to consumers. As the Commission stated in its Interconnection Order:

The price levels set by state commissions will determine whether the 1996 Act is implemented in a manner that is *pro-competitor* and favors one party (whether favoring incumbents or entrants) or, as we believe Congress intended, *pro-competition*.¹⁷

C. Additional Anti-competitive Concerns are Unfounded

25. AT&T alleges [Comments at 13] that “Bell Atlantic has taken steps to prevent competitors from rapidly taking away its customers” by offering long-term contracts that include early termination liabilities; they imply that such contracts are anti-competitive. The claim that Bell Atlantic’s long-term contracts with early termination liabilities are anti-competitive is contradicted by economic theory, real-world business practices and AT&T’s own consultants, Ordovery and Willig [at 11]. It also ignores the fact that Bell Atlantic’s flexibility to offer long-term contracts was granted by the Commission only after competitors entered the market and were successfully capturing Bell Atlantic customers. Competitors were creating service offerings that consumers wanted, and efficiency thus demanded that Bell Atlantic be given the same opportunity to compete.

26. Parties that voluntarily enter into long-term contracts (as is the case with AT&T) are better off as a result. In the case of special access customers, contracts permit suppliers to offer innovative services (in terms of price, quality, bundling etc) that cater to their customers’ unique demand and which are not available in standard month-to-month tariffs. Consumers obtain lower prices and achieve greater utility, thus increasing economic efficiency. Bell Atlantic also benefits because long-term contracts reduce its risk that long-lived investments will be stranded. Most early termination liabilities merely make customers pay what they would have paid absent the contract (i.e., what they would have paid based on the month-to-

¹⁷ Federal Communications Commission, FCC 96-325, First Report and Order in CC Docket No. 96-98, August 8, 1996 at ¶618, (Interconnection Order).

month tariffs or if they originally had signed up for the term that they eventually took the service). Early termination liabilities are not punitive in nature and do not penalize customers just because they switch providers. Moreover, early termination liabilities are a normal and healthy part of business practices used in many industries including the long distance market. Customers such as AT&T entered into these contracts when other competitive options were available, as is certainly the case today.

IV. MARKET SHARE SHOULD NOT BE THE BASIS FOR FORBEARANCE

A. Contrary To Intervenor's Claims, Potential Competition Can Discipline Price

27. Time Warner [Comments at 12], AT&T [Comments at 9-10], MCI [Comments at 8-9, 17] and Nextlink [Comments at 6], argue that the cost of connecting customers is much greater than Bell Atlantic claims and that barriers to expanding are high. These assertions are wrong.

28. From a market power perspective, it is not necessary for competitors to be connected to each and every building served by Bell Atlantic in order for Bell Atlantic's prices to be constrained. What is important from an economic perspective is whether in response to a significant and non-transitory price increase, barriers to entering the market (or expanding) are relatively low. If barriers are low, potential competitors can enter the market, increase market supply and reduce market price thereby making the price increase unprofitable. This process (of planning, entering and serving customers) does not have to happen immediately in order for Bell Atlantic's prices to be constrained. The *Merger Guidelines* state that:

The Agency generally will consider timely only those committed entry alternatives that can be achieved within two years from initial planning to significant market impact.¹⁸

¹⁸ Department of Justice and Federal Trade Commission Horizontal Merger Guidelines, April 2, 1992, revised April 8, 1997, at 51.

If competitors can enter the market and provide service within the two-year time frame, then entry is timely and it provides pricing discipline on the incumbent provider. Such is the case in the market for special access. The intervenors present no evidence that entry barriers are high; they merely assert that the cost to construct fiber networks or to connect customers to existing fiber networks are high. But even if entry is costly (or costlier than Bell Atlantic asserts) it does not mean that entry barriers are high or that firms will not enter in response to a significant and non-transitory price increase. Competitors already have constructed facilities directly linked to hundreds of buildings in the Bell Atlantic region, completely bypassing Bell Atlantic's network despite their ability to obtain access to Bell Atlantic's local loops through collocation. They would not have constructed these facilities unless they believed that the potential revenues exceeded the costs. From available evidence it is clear that fiber rings are being deployed within the two-year time frame contained in the *Merger Guidelines* and that competitors frequently announce plans to build and provide service well within the two-year time frame. For example:

- RCN recently announced plans to construct a fiber optic network in the Washington D.C. area to provide phone service, Internet access and cable TV services. Construction of the network will begin in the fourth quarter of 1999 and RCN plans to offer service to some residents in January 2000.¹⁹
- NEXTLINK Communications, Inc. began construction of an extensive regional fiber optic network in Pennsylvania in April 1995 with connections with Harrisburg, Reading, Lancaster, and Allentown. The backbone network connected these 4 areas and covered 21 counties and was completed by the first quarter of 1996.²⁰
- Metromedia Fiber Network plans to add over 200,000 fiber miles in the northeastern United States within a two-year period. The planned build-out will include intra-city fiber optic networks in Washington, D.C., Chicago and Philadelphia as well as an inter-city network between New York City and Washington DC.²¹

¹⁹ Telecommunications Reports, February 26, 1999.

²⁰ New Paradigm Resources Group, Inc., *1998 Annual Report on Local Telecommunications Competition*.

²¹ Metromedia Fiber Network, Inc. Form 10-Q, September 30, 1997.

- MCI and energy services provider DQE of Pittsburgh announced, in December 1997, the deployment of a fiber optic network in the Pittsburgh metropolitan area to be completed by mid-1998.²²
- FiveCom, Inc. has three networks in New Hampshire, all of which were built in 1996.²³
- In October 1996, Brooks Fiber announced the planned construction of three fully redundant synchronous fiber optic networks in the Stamford, Connecticut metropolitan area to begin by year end and be completed by second quarter 1997.²⁴
- In March 1997, Brooks Fiber announced plans to build a fiber network in the Portland, Maine area to be completed by the end of 1997.²⁵

29. Nor is it the case that on a forward-looking basis the market is skeptical of the ability of the Competitive Access Provider ("CAP") or Competitive Local Exchange Carrier ("CLEC") industry to compete with RBOCs. The large amount of resources that have been spent by IXC's to capture CAPs (such as AT&T's purchase of Teleport) is evidence that these firms and the market anticipate future growth opportunities. Moreover, contrary to the claims of MCI [Comments at 9] competitors are not having difficulty raising capital for investment projects. Richard A. Shaffer, founder of Technologic Partners, states:

Getting a CLEC up and running in enough markets to be viable takes about \$300 million, and that's far more than venture capitalists ordinarily provide. To date, public investors have been eager to make up the difference through high-yield bonds and initial stock offerings. For example, although it had only one month of revenues from a single city and a mere \$100 million in equity capital. Allegiance last January was able to borrow \$250 million.²⁶

30. It is important to keep in mind that demand for special access is relatively concentrated, thus increasing the ease of entry. Contrary to the claims of CTSI, Inc. and RCN Telecom

²² *Ibid.*, December 15, 1997.

²³ New Paradigm Resources Group, Inc., *1998 Annual Report on Local Telecommunications Competition*.

²⁴ Dow Jones Newswires, October 17, 1996.

²⁵ Energy Services & Telecom Report, March 27, 1997.

²⁶ Richard A. Shaffer, *Fortune Magazine*, October 26, 1998.

Services Inc. [at 5] and KMC Telecom, Inc [at 11] special access demand is relatively concentrated and the tables contained in our Affidavit support that claim. The criticisms of our Tables are wrong and based on a misunderstanding of the data. The main point in Table 1 is that demand for special access is concentrated in the top Bell Atlantic wire centers, no matter how the top Bell Atlantic wire centers are chosen. Twenty percent of Bell Atlantic's wire centers account for over 90 percent of special access demand. If special access demand were not concentrated in a few wire centers, this would clearly be a much lower number. Moreover, KMC's criticism of Table 4 in our Affidavit [at 25] is also without merit. The main point in Table 4 is that competitors do not need to collocate in all of Bell Atlantic's central offices in order to reach the majority of demand. And the fact that special access demand is less concentrated in the more urban areas is irrelevant because this has clearly not impeded competition.

31. Furthermore, AT&T's arguments demonstrate the fluid and rapidly changing competitive environment that Bell Atlantic faces. A snapshot of competitors' facilities becomes outdated the next day. For example, AT&T [Comments at 6] criticizes Bell Atlantic's Demonstration of Competition document because it includes a number of companies that have not yet entered the state at issue. However, as Bell Atlantic states in its reply, many of the companies mentioned by AT&T have already entered the markets and are providing service. This is further evidence of the relative ease of entry, and it should be helpful to the commission as to how it should evaluate forbearance petitions. Attempting to document where competitors have each and every piece of fiber in Bell Atlantic's territory is not only difficult and expensive, it is likely to be outdated in a short amount of time. Instead, the Commission should focus on whether entry conditions, in general, are such that competitors can enter or expand in response to a price increase.

B. Bell Atlantic's Special Access Prices Are Not Set At Supra-Competitive Levels

29. A fundamental error that Ordoover and Willig commit in their discussion of entry conditions in the special access market is their assertion [Affidavit at 5, 7, and 9] that Bell Atlantic's special access prices are at supra-competitive levels. In fact, this assertion is the linchpin for most of their analysis. For example, they state [Affidavit at 9] "More fundamentally, although McDermott and Taylor may well be right that technological progress has *reduced* infrastructure costs, especially with regard to fiber optic cable [McDermott/Taylor Aff. At 12-15], the fact that Bell Atlantic has lost so little market share to new entrants—despite rates that are well in excess of cost—is strong evidence that barriers to entry and expansion remain high." They further argue [Affidavit at 5] that we "make no attempt to demonstrate that market forces have in fact, reduced Bell Atlantic's special access rates to the forward-looking economic cost-based levels that would prevail in competitive markets for special access."

30. While there is general consensus and agreement that Federal switched access prices are above economic costs (in order to pay for part of the cost of the local loop), this is not the case for special access services. In fact, there is almost no debate that market special access prices are close to their economic costs. For example, the Commission stated in its interconnection Order:

For dedicated transmission links, states must use existing rates for interstate dedicated switched transport as a default proxy ceiling. We believe these rates are currently at or close to economic cost levels. Such rates were set based on interstate special access rates, which we found based on the record in the *Transport* proceedings were relatively close to costs.²⁷

In addition, evidence that competitors are indeed constraining incumbents' special access prices is available from a fiber deployment report by the Commission. The report stated:

²⁷ Interconnection Order at ¶ 821.

CAPs appear to have motivated local exchange carriers to price special access closer to cost.²⁸

This position is even accepted by executives from AT&T. In a recent conference sponsored by the Center for Public Policy Utilities Research at New Mexico State University, AT&T stated:

But, to look at the effects competition can have on local telecommunications service pricing, let's look at those segments of the local exchange marketplace where competition is beginning, and we will find price decreases that no regulator would have had the nerve to order.

Unlike the market for switched access services, dedicated access services have been subject to inroads by competitors for several years. Indeed, many of the firms that now offer competitive local services began by offering competitive dedicated services. As a result of this competition, AT&T has seen its unit cost per voice grade equivalent circuit decline by more than 80% since 1990. Who among us could have predicted such a result when the first competitive access providers were fighting with the RBOCs over their very right to exist?²⁹

34. Finally, contrary to Ordoover and Willig [Affidavit at 8], there is no externality issue regarding point-to-point special access services. Special access is different from switched access. The externality problem raised by Ordoover and Willig exists in theory because the end user receiving a call does not pay for receiving calls. If the end user were to pay for receiving calls, any supra-competitive pricing that IXCs would have to pay for terminating access would eventually be reflected in the price paid by the end user. Competitive forces would over time reduce prices. Special access customers pay for a dedicated point-to-point connection and the price does not vary by how many or few voice, data or Internet bits are originated or received. Special access customers pay for both originating and terminating traffic on the point-to-point

²⁸ Jonathan M. Krausharr, Industry Analysis Division, Common Carrier Bureau, *Fiber Deployment Update End of Year 1995*, at 34.

²⁹ Comments of R. Steven Davis, AT&T VP Law and State Government Affairs, presentation entitled "Price Restructuring in Telecommunications – Best Practices to Implement the Telecommunications Act" conference on Current Issues Challenging the Regulatory Process sponsored by the Center for Public Policy Utilities Research at New Mexico State University, March 9, 1999.

connection and, therefore, any legitimacy Ordoover and Willig's externality argument may have with respect to switched access does not apply to special access.

C. Capacity Is The Correct Basis To Measure Market Share

35. Numerous parties argue for a measure of market share based on revenue instead of one based on DS1 equivalents. As we discussed previously [Affidavit at 19-20] relying on market share to investigate market power concerns likely leads to significant errors in rapidly changing industries—especially those industries like telecommunications where monopoly provision was public policy. Nevertheless, examining changes in market share provides policy makers with useful information because unlike aggregate market share it is forward-looking and provides a better representation of market forces currently impinging on Bell Atlantic's services.³⁰ For a similar reason, the proper basis for calculating market share should be capacity rather than revenue because it is the best indicator of a firm's future competitive significance. This is confirmed by the *Merger Guidelines*:

Market shares will be calculated using the best indicator of firms' future competitive significance. Dollar sales or shipments generally will be used if firms are distinguished primarily by differentiation of their products. Unit sales generally will be used if firms are distinguished primarily on the basis of their relative advantages in serving different buyers or groups of buyers. Physical capacity or reserves generally will be used if it is these measures that most effectively distinguish firms.³¹

³⁰ Our use of changes in market share was criticized by Time Warner [Comments at 19] as being "convoluted" and requiring further explanation. Our statement that Bell Atlantic's average market share loss for high capacity services was 31.7 percent represents an absolute market share loss as of first quarter 1998, and not a comparison with the prior year.

³¹ *Merger Guidelines* at 25-26.

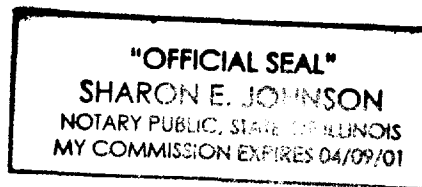
V. CONCLUSIONS

36. Opposition comments filed by intervenors fail to provide convincing evidence that Bell Atlantic retains market power in the provision of special access. The comments are based on flawed economic reasoning and clearly show an attempt by actual and potential competitors to maintain Bell Atlantic's unwarranted competitive restrictions for their ultimate benefit. Based on the available evidence, Bell Atlantic cannot profitably price special access services at supra-competitive levels. We conclude that forbearance will increase economic welfare and is clearly in the public interest.

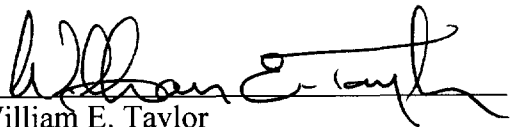
Karl McDermott
Karl McDermott

Subscribed and sworn to before me this
7th day of April, 1999

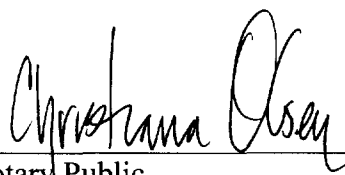
Sharon E. Johnson
Notary Public



My Commission expires 04-09-01


William E. Taylor

Subscribed and sworn to before me this
8th day of April, 1999.


Notary Public

My Commission expires September 18, 2003.